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IN THE

Supreme Court of the United States

OCTOBER TERM, 1952.

No. 123.

KAISER-FRAZER CORPORATION, *Petitioner*,

v.

OTIS & CO., *Respondent*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF OF RESPONDENT IN OPPOSITION

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OPINION BELOW

The findings and opinion of the District Court are set forth in the Record at pages 3089-3099. The opinion of the Court of Appeals by A. N. Hand, Circuit Judge, with Clark, Circuit Judge, and Brennan, District Judge, concurring, is reported in 195 F. 2d 838.

JURISDICTIONAL STATEMENT

The order of the Court of Appeals was entered on April 7, 1952 (R. 3099-3100). The petition for a writ of certiorari was filed on June 12, 1952. The jurisdiction of this Court is invoked under 28 USC § 1254 (1).

STATUTE INVOLVED

The statute involved is the Securities Act of 1933, 15 USC § 77a, et seq., particularly sections 11, 12, 14 and 17 of that Act.

QUESTIONS PRESENTED BY THE PETITION

1. In the circumstances of this case, was the failure to disclose that earnings for the last month and quarter shown in the registration statement and prospectus had been inflated by $3,100,000 a violation of the Securities Act of 1933 and of the warranty of the contract?

2. Did the Court of Appeals contravene the requirements of Rule 52(a) of the Federal Rules of Civil Procedure?

3. Where the issuer had filed and furnished to the underwriter a false and misleading prospectus for use in the sales of shares to the public, may the issuer nevertheless recover damages against the underwriter for refusal to purchase the shares for resale to the public?

STATEMENT

Kaiser-Frazer Corporation was organized in 1945 to engage in the manufacture and sale of automobiles. It was financed by the sale to the public of two issues of stock. The first issue, in late 1945, was sold to the public at $10.00 a share; the second, in early 1946, at $20.25 a share. The company realized about $50,000,000 from these two issues. The company has paid no dividends since its organization (PX 2, p. 3, p. 29; R. 1385).[1]

The present controversy relates to a proposed third public offering of stock in February 1948.

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[1] References to pages of the printed record will be made as "R. ." The prospectus of the offering in question was not printed in the record below but handed up to the court. A similar procedure is being followed with respect to this petition. The prospectus was introduced at the trial as Plaintiff's Exhibit 2 and is referred to here as "PX2". The Petition for Certiorari is referred to as "Pet. p. —".

The company began the actual production of automobiles in 1946 (PX 2, p. 3). These were two medium priced models called the Kaiser and the Frazer (R. 2756, 2349). For that year, 1946, the company showed a net loss in excess of $19,000,000 (PX 2, p. 7). During the first quarter of 1947, ending March 31, the company's losses continued, amounting to more than $3,000,000 (id.).

In May of 1947, officials of the company approached representatives of Otis & Co., which had headed the underwriting groups in the previous public offerings, to discuss the possibility of selling additional securities to the public. The Otis representatives advised the Kaiser-Frazer officials that a public offering was out of the question until the company showed substantial earnings (R. 1386-87, 2012-13).

During the latter part of 1947, Kaiser-Frazer officials resumed discussions with Otis as to a third public offering of securities (R. 1388-89). These discussions culminated in the underwriting contract which is the basis of this litigation. This contract was signed on February 3, 1948. Under its terms and subject to its conditions, Otis & Co., First California Company and Allen & Co., severally agreed to purchase an aggregate of 900,000 shares of Kaiser-Frazer's common stock for resale to the public at $13 per share (R. 13-31).

A registration statement had been previously filed by Kaiser-Frazer, and the prospectus which was part of the registration statement had been distributed to the public (R. 1392-94, 2825-32). The registration statement became effective on February 3, 1948, immediately after the underwriting contract was signed (R. 326-27), and the stock was actually offered to the public on February 3 and 4, 1948 (R. 2554-55). However, the underwriters terminated the offering on the latter date (R. 575-77). On the date set for closing, February 9, 1948, Otis and First California formally advised Kaiser-Frazer that they were terminating the contract and would not accept delivery of any shares covered

by the registration statement (R. 2710).[2] No shares of the issue were sold and delivered to the public.[3]

Kaiser-Frazer then brought the present action against Otis for damages for breach of its contract and for inducing breach by First California (R. 1-3). Otis' defense to this action was based primarily upon the grounds (1) that Kaiser-Frazer had made false and misleading statements to the underwriters and the public in the registration statement and prospectus which constituted a breach of warranty and a breach of condition precedent under the contract[4] and a violation of the Securities Act; and (2) that the pendency of material litigation, filed prior to the time for closing, also relieved the underwriters of any obligation to purchase the shares (R. 32-49).

The District Court, Clancy, J., sitting without a jury, decided all of the issues in favor of Kaiser-Frazer (R. 3057-3086). On appeal, the Court of Appeals unanimously reversed (Augustus N. Hand and Clark, Circuit Judges, and Brennan, District Judge (R. 3089-99)). The Court of Appeals, in an opinion by Judge Hand, decided that the registration statement and prospectus misrepresented Kaiser-Frazer's profit for the month of December and the last quarter of 1947; that this constituted a breach of warranty and a violation of the Act; and that accordingly Otis had a complete defense to the complaint (R. 3091). It, therefore, did not discuss the other errors in the judgment of the District Court presented by Otis on the appeal (R. 3091).

The relevant facts may be briefly summarized as follows: In early 1947, Kaiser-Frazer was faced with the fact, of

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[2] Allen & Co. likewise did not take or pay for any shares (R. 517-20).

[3] This action saved the public millions of dollars. The total price of the issue to the public was about $10,000,000. The shares thereafter declined in value. Their market price on the New York Curb Exchange dropped sharply from $13 per share (R. 2585-88) and went as low as 2⅞ (R. 1931). Their present market value on the Curb Exchange is between $4 and $5 per share.

[4] The underwriting contract provided that Kaiser-Frazer warranted as a condition of the underwriters' liability that "When the Registration Statement becomes effective, the Registration Statement and the Prospectus will fully comply with the provisions of the Act, and the rules and regulations and instructions of the Commission thereunder; and neither the Registration Statement not the Prospectus will contain any untrue statement of a material fact nor omit to state any material fact required to be stated therein or necessary in order to make the statements therein not misleading; . . ." (R. 14-15, 20; § 1 (c) and 3).

which it was advised by Otis, that it could not fulfill the desire of its top officials to sell additional securities to the public unless it could show an impressive record of profitable operations (R. 1386-87, 2012-13).

The year 1947 was a boom period for the automobile industry as a whole. There was great demand for automobiles due to their relative unavailability during the war, and it was possible to sell automobiles in large quantities at very high prices (R. 2291, P X 2, p. 5). Kaiser-Frazer determined to attempt to capitalize on this situation. At the time of its organization, the company had been widely represented as intending to produce low-priced automobiles (R. 2348-49). It had not done so. Its Kaisers and Frazers were in the medium price class (R. 2349), but despite this fact, the company had lost money on every one of them that it had produced. In these circumstances, in the early months of 1947, the company decided to turn out a new "model", to be sold at high prices and to yield a high profit, and to sell as many of these to its dealers as they could be induced to take. These automobiles were priced in the lower Cadillac price range (R. 2756, 2921), but they were exactly the same car as the cheaper Kaiser or Frazer, except for upholstery and trim (R. 1337, 1951).

In the initial month of volume production of these high-priced and high profit "models", May 1947, the company was able to show a profit for the first time in its history (R. 2751). Thereafter, for a few months until November 1947, the company's profits showed a spectacular increase (R. 2751). These boom earnings, however, were due primarily to the sales of the high-priced models. During the five months' period of 1947 from August 1 to December 31, at least 68% of Kaiser-Frazer's profits on automobiles were due to the sales of these models (R. 2760).

From the time that it resumed negotiations with Otis & Co. in the latter months of 1947, until the contract was signed on February 3, 1948, the company consistently represented to Otis and the other underwriters that the volume of sales of these models was continuing and that it had no

reason to anticipate a decline (R. 1509-11, 1515, 1603, 1502). This was contrary to the fact. Well before the registration statement became effective, the company knew that it had come to the end of the road on the profitable operation of selling high-priced cars. Beginning in the middle of October 1947, at the urgent insistence of its Sales Department (R. 2809-10, 2812), the company began drastic cutbacks in its production of these models. The result was that such production dropped from over 50% of total output in early October (R. 2777) to less than 20% by the time the registration statement became effective (R. 2754, 2760); sales of these models to dealers dropped from 9,176 in October 1947 to 3,217 in January 1948 (R. 2754); and projected production of these models for the five months after the proposed offering was about 16% of total production (R. 2766-67). There is no claim and no evidence that Otis knew these facts.

These facts were also concealed from and misrepresented to the public in the registration statement and prospectus which were finally amended on February 3, 1948 and became effective on that date. In its registration statement and prospectus the company did not disclose that 68% of the company's profits were derived from the sale of the high-priced models, and it misrepresented and concealed the fact that the demand for these models had drastically declined and that the company had already reflected such decline in its internal operations.[5]

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[5] The prospectus stated (PX 2, p. 5):

> "Both the Kaiser Custom and the Frazer Manhattan [the high-profit models] are in the high priced automobile field . . . . The public has since the inception of production by the Corporation and is at the present time purchasing high-priced automobiles in numbers much greater than was the case prior to the last war. *The Corporation is, of course, not in any position to predict how long this condition will continue.*" (emphasis supplied)

Of course, the company was not only in a position to "predict" but had "predicted for purposes of its own operations that its sales of high-priced cars would decline. They had already declined and the company had cut production accordingly (see text).

Before the Court of Appeals Otis urged that the concealment and misrepresentation described was a breach of warranty providing Otis with a complete defense to the action. The Court of Appeals found it unnecessary to rule on this (R. 3091).

This adverse turn in the company's fortunes had full impact upon the company's earnings for December 1947. In that month the company's net profits declined from an average of about $4,700,000 in each of the two preceding months [6] to only $638,226.97 as shown by the company's own operating report for December 1947 (R. 3096).

If Kaiser-Frazer had used the net profit figure of $638,226.97 for December in the registration statement and prospectus, the securities could not have been sold (R. 2127-28). Accordingly, the company used instead a "net profit" figure for December of $4,009,382.53. It arrived at this sum by the simple process of adding to its December net profits, as shown by its own accounts, the figure of $3,371,155.56. This figure was carried on its books as "*Prior* Months' Adjustments" (R. 3096).[7] It reflected principally the results of inventory writeups. These write-ups were not allocable to the month of December or the last quarter of 1947, but to the entire year's operations and to prior years (R. 3095, 3096). There is no testimony in the record which even attempts to justify this procedure on the basis of permissible accounting principles.[8]

The Court of Appeals held that this constituted a material misrepresentation of fact which violated the Securities Act of 1933 and constituted a breach of Kaiser-Frazer's warranty to the underwriters. The court pointed out that,

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[6] The registration statement showed only a combined figure for October and November net profit of $9,406,000. Actually this figure was misleading. November earnings had already declined showing that the company's short-lived boom was at an end. November earnings were approximately $2,000,000 below October (R. 2751).

[7] The company's "Consolidated Statement of Income and Expense" for December 1947, prepared for its own use, showed the results of the month's operations as follows (R. 3096):

"Net Profit or (Loss) for the Month of December, 1947	$ 638,226.97
Prior Months' Adjustments (see notes)	3,371,155.56"

The total of these two figures, $4,009,382.53, to the penny, was used as December "net profits" for purposes of the registration statement and prospectus (PX2 p. 7).

[8] The figures were not certified by independent auditors but were provided on the company's own responsibility (R. 3093).

as the company's own books showed, its December earnings were nowhere near the $4,009,000 shown in the registration statement and prospectus, but were rather "in the neighborhood of $900,000";[9] that the corporation knew on February 3, 1948 when the registration statement became effective that its profits for December were less than $1,000,000; that its misrepresentation of these profits by the simple process of adding "Prior Months' Adjustments" to actual December profits, could not be justified on accepted accounting procedures; and that this misrepresentation, particularly in view of the brief period of the company's earning history and the speculative nature of the enterprise, was material and misleading (R. 3095-97).

According to the court, the company's representation of its December earnings "was $3,100,000 short of the truth" (R. 3097).

The court also held that the footnote that appeared in the prospectus relating to the earnings for the last quarter of 1947 was "entirely insufficient" to disclose the nature and source of the "net profit" figures as shown in the prospectus. As the court stated, "No one reading [the footnote] would have been put on notice that the actual profit for December was less than a fourth of what was indicated by the table [of earnings]."[10] (R. 3097)

The court then proceeded to discuss Kaiser-Frazer's contention that Otis had "full knowledge" of the facts as to the December earnings prior to the time it entered into the contract, and could not now rely on these facts as a defense. Neither the Court of Appeals nor the District Court

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[9] This figure was composed of the $638,000 earnings and approximately $260,000 of the inventory adjustment which properly belonged in December and not to prior months (R. 3096 and note).

[10] The footnote merely stated:

> "The tentative information for the quarter and year ended December 31, 1947, reflects various substantial year end adjustments including provision for certain reserves and a material increase in inventories to conform to the results of a complete physical inventory taken by the Corporation as of December 31, 1947." (PX2, p. 7)

found that Otis had such knowledge,[11] but the Court of Appeals held that even if Otis had knowledge of the facts, under familiar principles of law, relief could not be granted to Kaiser-Frazer because the performance of the contract would have involved a fraud on the public and would contravene provisions of law and public policy (R. 3098-99).

ARGUMENT

The decision of the Court of Appeals does not present any novel or important question of legal principle warranting review by this Court. It involves merely the application of settled principle to the facts of this case. It is an action on a contract which is in the federal courts only because of diversity of citizenship.[12] It involves no substantial question of construction of any federal law. It does not conflict with any decision of this Court, and the decision of the Court of Appeals is plainly correct. Accordingly, no ground for review by this Court exists.

Construction of the Securities Act. The contract contained a specific warranty that Kaiser-Frazer would prepare and file a registration statement and a prospectus to be used in the public offering of the securities, and that when the filing became effective (R. 14, § 1(c)), these documents would comply with the requirements of law and would contain no misrepresentations or material non-disclosures (R. 14, 15, Section 1(c), see *supra*, p. 4, footnote 4). Com-

[11] The record shows that Otis did not have knowledge of the essential facts but was affirmatively misled. When Otis' representative, Kissell of Jones, Day, Cockley & Reavis received an intimation as to adverse December figures, top executives of the Company flew to New York to assure him the information was wrong. He was told various stories including the false statement that December advertising had through oversight been charged twice. (R. 1531-32, 1932, 1941-42, 1928-29). The figures for the last quarter and year 1947, and the footnote on page 7 of the prospectus, were added in the absence of any representative of Otis and underlying figures were never supplied to Otis (R. 1532-33, 1647, 1500). The contrary statement at p. 17 of the petition is flatly unsupported by the record. Otis also offered to prove that Kissell was told that the entire summary had been cleared with the Securities and Exchange Commission, which was false (R. 1540-41, 1561-63, 1616-19).

[12] The action was in fact originally brought in the Supreme Court of the State of New York and removed because of diversity of citizenship (R. 1, 3).

pliance with this warranty was expressly made a condition of the underwriters' obligation (R. 20, § 3). Kaiser-Frazer breached the warranty by filing and furnishing to the underwriters a registration statement and prospectus which misrepresented earnings for December and the last quarter of 1947. There can be no doubt that these earnings were grossly misrepresented, and that the misrepresentation was material. This adequately appears from the opinion of the court below and from the Statement in this brief, and we shall not elaborate the point. The argument of the petition (p. 19) that the Court of Appeals erred in its application of the Securities Act and in holding that there was a material misrepresentation of fact is entirely without merit.

Rule 52(a). Kaiser-Frazer nevertheless urges (Pet. p. 13) that this Court should review the decision of the Court of Appeals because that court "disregarded" Rule 52(a) by rejecting various "findings" of the District Court (Clancy, J., sitting without a jury). Kaiser-Frazer urges that the District Judge "found" that the earnings statement in the prospectus was not misleading; that the Court of Appeals "merely stated that it could not agree with that finding", but did not expressly characterize the finding as "clearly erroneous" as required by Rule 52(a) (Pet., p. 16). There is no merit in that contention.

The facts relating to December and last quarter earnings, 1947, were not in dispute. They were taken entirely from the company's own books and records (R. 1247-48). The only question was whether it was a misrepresentation for Kaiser-Frazer to add to "net profits" for December and the last quarter of 1947 the sum of several millions of dollars representing inventory writeups and other "adjustments" attributable to operations for the entire year and prior years. There is no question that the addition was made. The only issue was whether it constituted a material misrepresentation. The Court of Appeals concluded

that the represented earnings were "$3,100,000 short of the truth." (R. 3097) The Court of Appeals was entirely and obviously correct.[13]

Enforceability of the Contract. Kaiser-Frazer's final point is that the Court of Appeals erred in holding that, even if Otis had known the facts as to December and last quarter earnings, the contract between the parties was unenforceable (Pet., p. 5). Neither the Court of Appeals nor the District Court found that Otis had "full knowledge of all the facts" as Kaiser-Frazer contended. The District Court made no finding as to knowledge. The Court of Appeals stated only that "there is some support" for the view that Otis was informed of December earnings, but it regarded the point as unimportant in the context of the case because even if Otis had full knowledge, the contract would be unenforceable. The court pointed out that this is not a case of an ordinary contract of purchase and sale between two parties, but a case in which the interest of others than the parties to the contract is involved and in which performance of the contract as contemplated by the parties by public sale of the shares would defraud the public and be contrary to law and public policy. ". . . whatever the rules of estoppel or waiver may be in the case of an ordinary contract of sale," the court held, it is clear that a contract will not be enforced even if full knowledge of the facts by the contracting parties is assumed, where the performance of the contract would be a

[13] Kaiser-Frazer did not question the fact, and indeed did not even put an accountant on the stand to rebut Otis' accounting testimony that the addition of "Prior Months' Adjustments" to December earnings violated accepted accounting practice (R. 1307, et seq.). Its only answer was in the nature of confession and avoidance. It presented testimony of one of its staff accountants who sought to show that by disregarding Kaiser-Frazer's established method of accounting, December earnings could have been padded by other means so they would be only $1,200,000 less than represented (R. 1718-23, 1799-1800). The Court of Appeals rejected this approach on the ground that December figures must be shown on a basis consistent with prior figures in the same table of earnings (R. 3096). Even assuming that this approach were permissible, December and last quarter earnings would nevertheless have been materially misrepresented by $1,200,000.

fraud upon the public, contrary to public policy, and a violation of law (R. 3098-99).[14]

In so holding, the court applied the familiar principle of law that a bargain, performance of which would tend to harm the public by deceiving it as to material facts and which would also contravene provisions of law and public policy, is illegal and unenforceable. RESTATEMENT OF CONTRACTS, §§ 577, 598; 6 WILLISTON, CONTRACTS (Rev'd 1938) § 1738, and particularly text and cases cited at p. 4912, n. 15, p. 4913, n. 17 and p. 4914, n. 21; *Randall* v. *Howard*, 2 Black 585, 588; *Dent* v. *Ferguson*, 132 U. S. 50, 64; *Fox* v. *Gardner*, 21 Wall. 475, 480; *Materne* v. *Horwitz*, 101 N. Y. 469, 5 N. E. 331 (1886); *Reiner* v. *North American Newspaper Alliance*, 259 N. Y. 250, 181 N. E. 561 (1932); *Jackson* v. *Bryant*, 33 Ohio App. 468, 169 N. E. 825 (1929).[15]

Kaiser-Frazer argues (Pet. p. 8) that this part of the court's decision is in conflict with the decision of this Court in *A. C. Frost & Co.* v. *Coeur D'Alene Mines Corp.*, 312 U. S. 38. That is not true. The *Frost* case and the present case differ not in the legal principles involved, but in the facts to which they were applied. The familiar doctrine of unenforceability, which was applied by the court below, is plainly reiterated in the *Frost* case. That case repeats the "rule that contracts in contravention of public policy are not enforceable", and defines the basis of the doctrine in these terms: "No one can lawfully do that which tends to injure the public or is detrimental to the public good" (312 U. S. at 44).

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[14] The court further pointed out that Section 14 of the Securities Act would support the view that even if Otis had knowledge of the facts, it would not be estopped to assert as a defense the fact that Kaiser-Frazer had filed a false and misleading registration statement in violation of law. Section 14 provides that any stipulation or provision to waive any requirement of the Act is void (Opinion, footnote, R. 3098). It should also be noted that the contract in this case provides that any investigation made by the underwriter shall not operate to relieve the issuer of its full responsibilities under its warranties, including its warranty that the registration statement and prospectus, when they become effective, will be complete and accurate (R. 25 § 4 (a)).

[15] The citation of State cases is here limited to New York and Ohio, since the contract was made in New York and closing was scheduled in Ohio. Other states are in accord. See texts cited.

The *Frost* case involved nothing more than an "absence of registration" under the Securities Act (312 U. S. at 41). It did not involve an attempted fraud on the public or any element of deceit or misrepresentation. In *Frost* this Court held that the mere failure to register, without more, did not render a contract of purchase and sale unenforceable between the parties. The Court emphasized that "the challenged contract bears no evidence of criminality and is fair upon its face" (*id.* at 42). That, of course, is not the situation in the present case, which involves gross misrepresentations of earnings designed to defraud the public and to induce it to purchase $10,000,000 of securities in violation of criminal and civil statutes [16] and common law principles designed to prevent and punish frauds on the public.[17]

In the *Frost* case this Court referred to the "protean basis" of the doctrine of unenforceability and clearly recognized that its application to cases involving the Securities Act must necessarily be determined by the facts of each case (312 U. S. at 44). The essentially *ad hoc* nature of the doctrine applied in the *Frost* case is illuminated by the decision of the Court of Appeals for the Second Circuit, which also decided the present case, in *Judson* v. *Buckley*, 130 F. 2d 174 (CA 2, 1942), cert. den. *Buckley* v. *Judson*, 317 U. S. 679. Two of the judges who decided the present case also participated in *Judson* (A. N. Hand and Clark, C. J.), and the opinion in both cases was written by Judge Hand.[18] The *Judson* case involved a misrepre-

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[16] Section 17 (a) of the Securities Act of 1933 (15 U.S.C. § 77 q (a); Rule X-10B-5 under the Securities Exchange Act of 1934; Section 9(a) (4) of the Securities Exchange Act of 1934 (15 U.S.C. § 78 i (a) (4); and the Mail Fraud Statute (18 U.S.C. § 1341) are among the prohibitions which would be offended by sale of the stock to the public by the false prospectus. See also, p. 15 *infra*.

[17] See RESTATEMENT OF CONTRACTS; WILLISTON ON CONTRACTS, both *loc. cit. supra*; *Rex* v. *Kylsant* [1932] 1 K. B. 442.

[18] The Securities and Exchange Commission, which in the *Frost* case had filed a memorandum attacking the suggestion that all contracts for the purchase of securities should be held unenforceable because of the absence of registration, filed a brief in *Judson* urging that the Court refuse enforcement because *Judson* involved an affirmative misrepresentation rather than an absence of registration. See 130 F. (2d) at 180, see also footnote 21, *infra* p. 15.

sentation in the registration statement of the ownership of the securities offered for sale. Primarily because the misrepresentation could not "mislead prospective purchasers as to the value of the stock or really prejudice them in any way" and the "public offense" committed was therefore "one of little practical significance" (130 F. 2d at 179), the Court of Appeals granted enforcement of the contract as between the parties.[18a]

This contract (unlike the agreement to sell without registration in the *Frost* case) would have been unenforceable before the Securities Act of 1933 was enacted. See authorities p. 12, *supra*. It belies the spirit and history of that statute to suggest that it was designed, by implication or otherwise, to legitimize or make enforceable for the first time such agreements to defraud investors.

Kaiser-Frazer argues (Pet. pp. 9, 10) that the doctrine of unenforceability cannot be applied by the courts in any case involving the Securities Act because that Act does not contain a provision like Section 29(b) of the Securities Exchange Act of 1934, which expressly makes void contracts the performance of which would violate the provisions of the Act, or the rules and regulations thereunder (Sec. 29 (b), 15 U. S. C. § 78 cc (b)). As the *Frost* case recognizes, the absence of express statutory provision is, of course, not determinative. The decision below rests on general principles of law which establish the power and duty of the courts as a matter of statutory law to refuse enforcement of contracts in appropriate circumstances.[19]

In any event, by Kaiser-Frazer's own argument, the fact that the Securities Exchange Act expressly makes contracts in violation of its rules void (Sec. 29 (b)) outlaws the present contract. For the performance of this contract

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[18a] Kaiser-Frazer expresses concern for the effect of the holding below on innocent underwriters (Pet. pp. 12, 13.). The basis of the doctrine of unenforceability of course the courts requires to protect an innocent underwriter in his rights under the contract while denying relief to the guilty issuer. RESTATEMENT OF CONTRACTS § 599.

[19] See *The Bank of United States* v. *Owens*, 2 Pet. 527; *Continental W. P. Co.* v. *Louis Voight & Sons Co.*, 212 U. S. 227.

would violate the provisions of Rule X-10B-5 issued under the Securities Exchange Act of 1934[20] as well as the similar provisions of the Securities Act of 1933.

Finally, Kaiser-Frazer argues (Pet. p. 11) that to refuse enforcement of the issuer's claim against the underwriter here would hinder the purposes of the Securities Act. In this connection it relies upon the Court's statement in the *Frost* case that to refuse to permit an underwriter to recover against an issuer merely because of the failure to register the securities might result in "actual hindrance" of the purpose of the Act.[21] We do not challenge the point that there may be instances in which the refusal of enforcement would hinder the achievement of the purposes of the Securities Act. However, we believe that in a case such as is here presented, involving an entirely unexecuted contract and an attempt to defraud the public, it is clear that the refusal of enforcement will materially advance achievement of the purposes of the Act. This case involves an

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[20] Rule X-10B-5 reads as follows: "*Employment of Manipulative and Deceptive Devices*—It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The substantial identity of the provisions against false statements contained in the Securities Act and the Securities Exchange Act are discussed in Loss, Securities Regulation, pp. 811, 824, 832.

Section 29(b) of the Securities Exchange Act of 1934 renders "void" contracts performance of which involve a violation of "any provisions of this title or of any *rule or regulation* thereunder". (Emphasis supplied)

[21] Justice McReynolds, writing for the Court, did not elaborate on this point, but merely referred to a memorandum filed by the Securities and Exchange Commission which pointed out that the adoption of an absolute rule that failure to register rendered contracts unenforceable would in some instances operate to prejudice investors: for example, where investors had actually purchased securities from the underwriter and the underwriter refused to account to the issuer for the proceeds (See 312 U. S. at 43). Subsequently, in *Judson* v. *Buckley*, 130 F. 2d 174 (CA 2, 1942), cert den. *Buckley* v. *Judson*, 317 U. S. 679, the Commission filed a brief urging that the rule of nonenforceability be applied in a case where an actual misrepresentation had been made in a registration statement. The *Judson* case is discussed, *supra*, p. 13.

attempt by an issuer to collect damages from an underwriter who assumed the burden and risk of refusing to consummate a deal which, if carried out, would have resulted in the sale to the public of $10,000,000 of securities on the basis of gross misrepresentation of the company's earnings,[22] with consequent losses to the public running into the millions.[23]

The sale of securities to the public in these circumstances is the basic evil that the Securities Act was designed to prevent. This evil was not effectuated in this case because the underwriters were unwilling to accept and resell to the public the securities which Kaiser-Frazer sought to issue on the basis of false and misleading representations. The decision below will strengthen the fundamental purpose of the Act which is to prevent issuers from making false statements to sell securities.

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[22] Kaiser-Frazer's petition appears to suggest that the transaction in issue should be considered as a private bargain involving just the underwriters and the issuer, and not the public. The transaction in this case in all respects followed established forms and practices used in the underwriting of securities for distribution to the public immediately after the contract between the underwriter and issuer is signed. As the court below stated (R. 3098-99), and as is obvious from the nature of the transaction and the terms of the contract, the essence of the deal was a public offering to be made immediately after the registration statement became effective and upon its basis. Kaiser-Frazer was required to prepare and file a registration statement and prospectus which would be truthful and complete (R. 14, § 1(c)). It was to send copies of the prospectus to securities dealers designated by the underwriters and to furnish the underwriters with such further copies "as may be required for use in connection with the public offering of the Shares" (R. 17, §§ 2(d) and (f)). The registration statement and prospectus showed the public offering price which was based on the market at the time the statement became effective (PX 2, p. 1, R. 2585). The court below was clearly correct in stating that the contract between the issuer and the underwriters "was but the initial step in the public offering of the securities which would necessarily follow" (R. 3098-99).

Kaiser-Frazer's suggestion that the registration statement could have been amended presumably after it became effective and before public offering, is contrary to the contract and to the essential mechanics of securities distribution. Time was of the essence as is customary in a transaction of this sort. The securities had to be sold when planned. The price was fixed on the basis of the market at that time. It is for that reason that, as we have emphasized, Kaiser-Frazer warranted as a condition of the underwriters' obligation that the registration statement would be truthful and complete *when* it became effective (R. 14, § 1 (c)).

[23] The stock which was to be sold to the public at $13 per share declined to below $3 per share and the company had losses of $39,000,000 for 1949 and $20,000,000 in 1950 (R. 1931). The present market is between $4 and $5 per share on the New York Curb Exchange.

The Act places the obligation for full and accurate disclosure squarely upon the issuer (§ 6(a), 15 U. S. C. § 77 f (a)). The issuer must prepare, sign and file the registration statement, and is subject to criminal as well as civil liabilities for any misrepresentations that are made (§ 6 (a), 24, 17, 11, 15 U. S. C. § 77 f (a), x, q, k). The Act charges the underwriter only with the responsibility for "reasonable investigation". The underwriter is not criminally liable, and is civilly liable to investors only if it fails in its obligation of "reasonable investigation". (§ 11 (b) (3), 15 U. S. C. § 77 k (b) (3)). Even in such case it may, according to the statute, obtain "contribution" from the issuer (§ 11 (f), 15 U. S. C. § 77 k (f)).[24]

In short, the objective of the law is to insure that issuers refrain from misrepresentations and concealments, and to encourage underwriters to refuse to market securities where the issuer has not fully complied with this obligation. The holding below effectuates this policy by denying the aid of the courts to issuers who have violated their moral, legal and contractual duty and by encouraging underwriters to refuse to proceed with the sale of securities to the public in those circumstances. The contrary ruling urged by Kaiser-Frazer would defeat that policy. It would lend the aid of the courts to issuers who have violated the basic requirement of the law and public policy, and would subject underwriters to peril and penalty for refusing to consummate a fraud on the public.

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[24] The underwriting contract in this case reflects and reinforces the plan of the Act by the following provisions: (1) The issuer warrants that the registration statement and prospectus will be complete and accurate, and this is a condition of the underwriters' contractual liability (R. 14 § 1 (c), R. 20 § 3); (2) the warranties of the issuer remain fully operative regardless of any investigation made by or on behalf of the underwriter (R. 25 § 4 (a)); and (3) the issuer agrees fully to indemnify the underwriter if it is subjected to liability on account of any representations or concealments by the issuer in the registration statement or prospectus (R. 24, § 4 (a)).

CONCLUSION

For the reasons stated, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1952.

No. 123.

KAISER-FRAZER CORPORATION,
Petitioner,

against

OTIS & CO.,
Respondent.

PETITIONER'S REPLY BRIEF.

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PETITIONER'S REPLY BRIEF.

Respondent's brief attempts to create a wholly false impression as to the purport of the decision of the court below.

In its statement of questions presented (Br.[1] 2) respondent says that the case involves the question of whether a certain claimed failure of disclosure in a prospectus involved "a violation of the Securities Act of 1933 and of the warranty of the contract". There is nothing in the opinion of the Court of Appeals which either expressly or by implication could be construed as a determination that the defense of breach of warranty was available to respondent. To the contrary, it was implicit in the opinion that this defense was not available to respondent. The sole ground for reversing the decision of the District Court was that

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[1] Reference is to pages of respondent's brief dated August 1, 1952 in opposition to the petition.

the contract was illegal by virtue of the provisions of the Securities Act of 1933.

The Court of Appeals found the Prospectus misleading in one respect only, that is, the manner in which earnings for the last quarter of the year 1947 were represented. In respect of this portion of the Prospectus, the Court of Appeals stated "representatives of Otis [respondent] at least were informed of the actual December earnings and apparently took part in the preparation of the registration statement and prospectus"[2] (R. 3098). The court then proceeded to state that the knowledge of Otis was immaterial since the contract was illegal by virtue of the provisions of the Securities Act of 1933.

Respondent states that the contract would have been illegal even in absence of the Securities Act of 1933 (Br. 12, 14). There is nothing in the decision of the court below to this effect. Furthermore, this argument is based upon an assumption of facts not involved in the present action.

A considerable portion of respondent's brief (Br. 3-8) is devoted to the claim that petitioner concealed the true conditions of its sales and a downward trend in its earnings. This claim was made by respondent both in the District Court and in the Court of Appeals. The District Court specifically found against this claim (R. 3067, 3077-79). Its findings were based on extensive evidence (R. 1358, 1443-80, 1568-1603, 1825-43, 1849-57, 2101-11, 2139-2204, 2757; Plaintiff's Exhibits 2, 97, 98, 101, 103, 105, 107-120, and Defendant's Exhibits 31-73, 79-83, 103, 137-147, 199-211). These findings were left undisturbed by the Court of Appeals.

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[2] These documents were prepared prior to the execution of the contract. Clearly, if respondent had full knowledge of the facts claimed to have been misrepresented therein, the defense of breach of warranty would not lie. *Bennett* v. *Buchan*, 76 N. Y. 386 (1879); *Williston, Sales*, Section 207, Rev. Ed.

Throughout respondent's brief it is implied that petitioner was guilty of wilful fraud or misrepresentation. For instance, the transaction is referred to "as an attempt to defraud the public" (Br. 15). A claim of fraud was made before the District Court and the District Court rejected it (R. 3068). Nothing in the decision of the Court of Appeals even indicates that that court considered that there was any fraud or wilful concealment.

In the light of these facts respondent's argument that the contract could have been held illegal on the basis of some general public policy (Br. 12) or under the provisions of Section 10(b) of the Securities and Exchange Act of 1934 (Br. 14) is totally lacking in merit. In absence of fraud, neither basis would exist for holding the contract unenforceable.

Under such circumstances, therefore, the Court of Appeals based its decision solely upon the assumption that the Securities Act of 1933 rendered the contract illegal and unenforceable. In so doing, it held that a contract which was legal and valid on its face would not be enforced because that Court believed that its performance would involve a violation of the provisions of the Securities Act of 1933. That is precisely what this Court held to the contrary in the case of *Frost & Co.* v. *Coeur D'Alenes Mines Corp.*, 312 U. S. 38.

As to the failure of the Court of Appeals to comply with the requirements of Rule 52(a), respondent (Br. 10) inaccurately states that there were no disputed questions of fact before the District Court. The facts as to the proper presentation of earnings were in dispute before that Court. As shown in the petition (p. 16) there was substantial evidence that such earnings were presented in accordance with good accounting practice.

Respondent (Br. 9) fails properly to present the Court of Appeals' interpretation of the requirements of the Securities Act of 1933. Were the facts as stated by respondent, there would be some basis for the argument that such requirements had not been complied with by petitioner. However, as pointed out in the petition (pp. 19-22), these were not the facts and the sole ground on which the Court of Appeals concluded that the Act was not complied with was that a footnote, which stated that substantial adjustments had been made, was not, in its opinion sufficiently explicit.

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